The vested interests and the common man as seen through monetary and fiscal policy: flooding Wall Street or Main Street?

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Abstract: There are many angles through which a critical observer can analyze the divergent class interests in most aspects of macroeconomic management. This paper examines the insistence of the financial authorities of all major economies in reviving economic activity through monetary and not fiscal policy, as a particularly clear example of favoring the vested interests over those of the common man. Close to a century after Veblen's writings on the subject, one can find many rhyming elements to the political landscape of the times. Today, the common man is often expressed by the 99%, and many accept that the dominant vested interest is that of global banks. Unlike Veblen's times, today's economists now have many historical experiments in economic management from which to consult. Employing logic, historical experience, and an understanding of our current global finance led capitalism, this article offers a preliminary institutionalist analysis of the mechanisms of current monetary policy that "flood" Wall Street while leaving employment, production and investment -Main Street- all but forgotten. The article then explains how the vested interests have abandoned fiscal policy and left a deflationary macroeconomic environment.

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The financial crisis that began in 2007-2009, which we will refer to as the Great Crisis, has set into effect a top down deflation *á la* Irving Fischer, where the collapse of the prices of financial instruments spreads outwards and downwards to the economy at large, depressing prices across the board. As Lavoie and Seccareccia (2011) recognize, the banking crisis in Japan that has lead to decades of low interest rates and low growth has now become a global phenomenon in the wake of the Great Crisis.

As we argue in this article, the authorities' response to the Great Crisis has been in favor of the interests of financial interests and against those of the common man. However, if one applies this general criteria, apparent contradictions quickly appear. Specifically, the governments of the major economies, grouped together as the G20, executed a coordinated U-turn in policy, applying fiscal stimulus at the beginning of the crisis and then moving towards fiscal austerity shortly thereafter. In heterodox circles, expanding fiscal policy is typically - and correctly - seen as a positive for the common man, while doing the same through monetary policy is not. To understand how this U-turn did not in fact represent a contradiction, we briefly trace its history, beginning with an enlightening quote from Krugman, who is a bit of a contradiction himself on this subject.

Krugman has been credited by many, including himself, for asking for more fiscal stimulus but having his recommendations fall on deaf ears. With this line of argument, Krugman ingratiates himself with those who advocate for the common man. However, if we carefully examine the paper he uses to burnish his credentials as a defender of the common man, we find this core proposition:

> first, if the liquidity trap is short-lived in any case, fiscal policy can serve as a bridge. That is, if there are good reasons to believe that after a few years of large deficits monetary policy will again be able to shoulder the load, fiscal stimulus can do its job without posing problems for solvency (Krugman, 1999)

This quote raises several lines of inquiry, but for our purposes here, we will only focus on the notion that fiscal stimulus can serve as a "bridge", to "shoulder the load" of economic stimulus until out of the "liquidity trap", at which point the preferred option of

managing the economy through monetary policy can be reinstated. Krugman's comments were obviously made well before the Great Crisis, but it is the idea that we will focus on, and indeed use as our hypothesis in weaving together the decisions that we document. Before moving on, we note that the quote is fully fitting for the official response to the Great Crisis, which has yet to pull major economies out of the "liquidity trap".

A tale of two G20 meetings

At the nadir of the panic of 2007-2009 that set off the Great Crisis, the G20 convened in London, and fully acknowledged that the world economy was in a global crisis that needed a global solution, even recognizing the need for a global relaunch that places the needs of employment at the center. The proposed measures considered the fiscal policy imperative of "an unprecedented and concerted fiscal expansion, which will save or create millions of jobs which otherwise would have been destroyed" (G20, 2009). Along with fiscal policy expansion, the G20 also stressed the implementation of exceptional measures on behalf of the central banks, particularly the accelerated reduction of interest rates, to be maintained over a certain period of time, along with the use of non-conventional instruments, while always ensuring price stability.

The Summit advocated using an expansionary fiscal policy and monetary policy, although from this moment forward, the emphasis has clearly fallen on supporting the financial systems of the world's major economies with measures taken by individual central banks and governments, including the European Central Bank (ECB). The London Summit argued that actions to relaunch growth cannot be effective before domestic credit and international capital flows have been restored: "We have provided significant and comprehensive support to our banking systems to provide liquidity, recapitalize financial institutions, and address decisively the problem of impaired assets" (G20, 2009). The resolution also expressly states that governments are committed to take all appropriate steps to restore the normal flow of credit through the financial system and to ensure the soundness of systemically important financial institutions.

Almost a year later, at the June 2010 Toronto meeting, the G20 again insisted on the need to strengthen financial systems against risk, but it is here that the group made the interesting turn from expansionary fiscal policies towards fiscal consolidation. Restoring the balance in the public accounts was now essential, while the exceptional measures in monetary policy maintained their importance. The new old rule was that "sound fiscal finances are essential to sustain recovery." (G20, 2010). Following our hypothesis, this would be the moment in which Krugman's criticism comes in: the accelerator of fiscal policy was not pressed long or hard enough to escape from the liquidity trap and return monetary policy to its prominence.

Although this document noted that in developed economies the implementation of fiscal adjustment measures can hamper recovery, it also made clear that failure to implement fiscal consolidation measures where they are necessary can undermine confidence and weaken growth. Yet the recommended plan was for fiscal adjustment, with the objective of reducing the fiscal deficits and public debt in relation to GDP. Perhaps the most relevant declaration in this sense is that "advanced economies have committed to fiscal plans that will at least halve deficits by 2013 and stabilize or reduce government debt-to-GDP ratios by 2016" (G20, 2010).

There was also mention of a reform of the financial system based on four pillars of robust regulation, effective supervision, changes to strengthen systemically important institutions and a transparent international assessment of the state of the financial system, in particular of institutions of systemic importance. All of these points imply maintaining the policy of low reference interest rates and the injection of liquidity by the central banks, all under an indefinite timeframe.

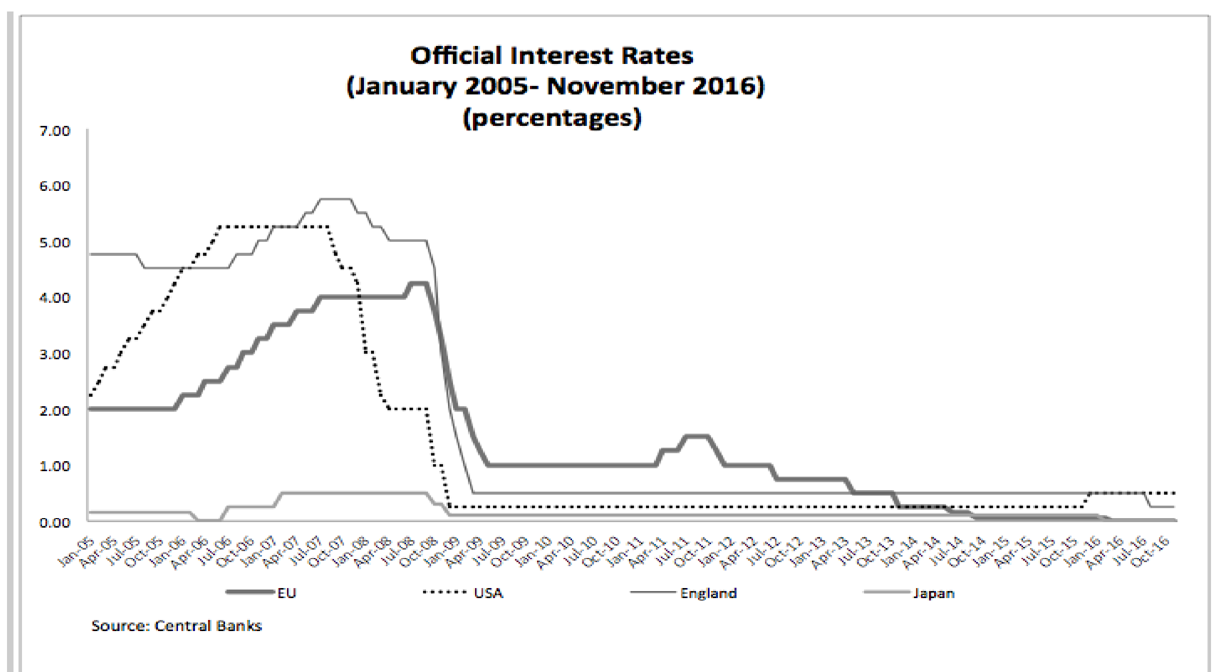
In the fiscal field, a policy of fiscal responsibility was implemented in the United States before the G20 meeting in Toronto. The Obama administration created in February 2010 the National Commission on Fiscal Responsibility and Reform. The purpose of the bipartisan commission was to generate recommendations for Congress to significantly tamper public deficit. A reduction of the deficit to 3 percent of GDP by 2015 was proposed, as is the need to achieve a primary surplus (The White House, 2010a). A Report of the National Commission on Fiscal Responsibility and Reform was presented in

December 2010, with a plan to reduce the public deficit from 8.9% in 2010 to 2.3% in 2015 and 1.2% in 2020. The reduction of public debt as a proportion of GDP is also considered. A set of measures to rationalize spending with the objective of reaching a primary surplus is established (The White House, 2010b).

Here we should note that in many spaces of debate over the shift away from fiscal expansion, the justifying academic research for austerity was Reinhart and Rogoff's 2010 *This Time It's Different*, based on dubious evidence and methodology. It may also be pertinent to note that the Toronto U turn was made shortly after Greece entered into its crisis phase, kicking off the Eurozone crisis in earnest.

Going forward and with several variations, the largest developed economies carried out fiscal policies in order to achieve a primary surplus and have sufficient public revenues to meet the financial requirements of public debt. A strong fiscal austerity policy was implemented in the Eurozone, ushering in recession, with the area's GDP contracting by 0.7% in both 2012 and 2013. Meanwhile, Japan has continued along into its third decade of stagnation.

While reversing fiscal expansion, a monetary policy that is qualified by the IMF and other international financial organizations as "accommodative" has been expanded. On the one hand, even at different times, there was a rapid and drastic reduction of the reference interest rate set by the central banks of United States, the United Kingdom and the Eurozone. In Japan, the central bank maintained the benchmark interest rate at levels close to zero. In 2014, the ECB, the Bank of England and the Bank of Japan further reduced their benchmark rates to zero or negative territory in 2016, as can be seen in Figure 1.



Far from escaping the "liquidity trap" associated with debt deflation, interest rates have continued to fall, at the same time that the most important central banks have been executing notable programs of debt swaps. As with the reduction in interest rates, these programs have not been implemented at the same time, notably in the case of the Eurozone. These measures have rescued the profits of banks, insurers and other finance firms. Parguez points out that this is an economic policy that gives *carte blanche* to the banks and allows them to reestablish profits that are not tied to profits from productive activity: “Nothing is undertaken to prevent a new flight to pure financial loans. Those rules cannot cure the real economy and restore the stability conditions” (Parguez, 2009: 25).

Austerity and deflation take hold

Now almost ten years removed from the beginning of the Great Crisis, observable fact demonstrates how depending on monetary over fiscal expansion did not achieve the stated goals of renewed growth and lowered levels of public indebtedness. We pose that the glaring disparity between what is, and what mainstream economics says should be, is

due to the fact that the economics used by the G20 and IMF is at the service of vested financial interests, and not the common man.

In 2016, after several years of running a fiscal policy based on austerity, accompanied by active monetary policy, economic activity in the advanced countries has produced widely known poor results; even inflation targets are not consistently met. The other notable result has been a stark increase in the balance sheets of the central banks of the largest advanced economies. According to information from the IMF (2016a), Federal Reserve and ECB assets were more than 30% of GDP at the end of 2016, when in 2008 they were below or around 10%. In Japan the figure was over 90%, while in 2008 it was slightly higher than 20%. A similar trajectory can be seen with public levels of indebtedness.

Despite such poor results in its stated objectives, the IMF has continued to insist upon its recommendations on monetary and fiscal policy. In a 2016 document, the IMF made the case for carrying out greater easing in monetary policy through purchases of assets and negative deposit rates, assuming that inflation expectations can be increased, thereby reducing the real borrowing costs of households and firms (IMF, 2016a: 30). Again, this has been the path undertaken for years without being able to stimulate demand, much less investment.

In the fiscal field the IMF has insisted on maintaining consolidation. Moreover, countries with public debts that have grown in recent years and that must make significant disbursements for social benefits, must make a credible commitments to strategies of fiscal consolidation. These can bee seen as the most relevant recommendations of the 34th meeting of the International Monetary and Financial Committee, held in the framework of the joint meeting of the IMF and the WB, in October 2016 (IMF, 2016b). These can also be seen as a continuation of the strategies crystallized in the Toronto G20 meeting.

Such a glaring divergence between stated goals, the tools used to achieve those goals, and the produced results, are not lost on the IMF: "A common theme, though, is that urgent policy action is needed on multiple fronts to head off repeated growth disappointments and combat damaging perceptions that are ineffective in boosting

growth and that rewards accrue only to those at the highest end of the income distribution" (IMF, 2016: 30).

The IMF is careful to conflate "disappointments" with "damaging perceptions". If history is a guide, in this equation the side to be combatted is not that of results, but rather that of perception. On the results side, there is in fact a fairly tight correlation between moments of official monetary expansion through the Fed and stock market performance, as shown in the below Figure 2.

Such information certainly backs our hypothesis that the policy action in response to the crisis has served the financial elite and those who benefit from their activities at the expense of the rest. We suggest that the above relation is causal, a visible result of the common man vs. vested interests dynamic. The justifications from mainstream economics in support of G20 and IMF policies have proven highly ineffective in predicting future results. Following our hypothesis, we believe that the inability to learn from errors confirms that stated objectives have simply been a smokescreen in order to roll out public policies that heighten wealth inequalities.

As Galbraith demonstrated before the outbreak of the Great Crisis, the forces affecting the distribution of wages and incomes are both systemic and macroeconomic. Explaining the behavior of economies since the 1980s, he emphasizes that "... these forces are largely financial in character. They have to do with the first and foremost with interest rates, the flow of financial investments, and the flow of payments on debts, internal and international" (Galbraith, 2012: 289). When the financial giants suffer, all below them wilt, and no amount of monetary stimulus can pull them out of deflation or the liquidity trap, as seen most clearly by the case of japan.

With activist fiscal policy all but abandoned, increases in employment and production, which would be in the general good of the common man, have been tepid at best. Alongside growing social inequality there is a notable weakness in the investment process. In the period from 2008 to 2017, the IMF estimated an annual investment growth in advanced economies of 0.3% (IMF, 2016c). The pairing of debt deflation and economic stagnation is becoming consolidated in most G20 countries.

Conclusions

Through the lens of vested interests, we can see how the coordinated response to the Great Crisis by the G20 and the IMF has always been in favor of financial interests, and how the original push for fiscal expansion does not have to be seen as a contradiction.

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